No. 14,402

IN THE

United States Court of Appeals

For the Ninth Circuit

OTIS A. KITTLE,

Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

Upon Appeal from the Tax Court of the United States.

BRIEF OF APPELLANT.

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Subject Index

	Page
Jurisdiction	1
Statement of the case	1
Specification of error	5
Summary of argument	6
Argument	6

Table of Authorities Cited

Cases

	Pages
Anderson v. Helvering, 310 U.S. 404, 84 L.Ed. 1277	9, 10, 11, 14
Helvering v. Elbe Oil Land Development Company, 303 U.S. 372, 82 L.Ed. 905	14
Kirby Petroleum Company v. Commissioner, 326 U.S. 599	7, 13, 14

Codes

Internal Revenue Code of 1954:

Section 7482	1

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BRIEF OF APPELLANT.

JURISDICTION.

This court has jurisdiction under Section 1141 of Title 26 U.S.C.A., now Section 7482 of the Internal Revenue Code of 1954. The tax return by appellant for the year in question was filed with the Collector for the District of Nevada, which is within the Ninth Circuit.

STATEMENT OF THE CASE.

Appellant filed an amended income tax return for 1945 claiming a net operating loss carry-back from the year 1947. That carry-back, in part, grew out of

the treatment given by appellant in the 1947 return to $7,936.52 received by him from Oliver Iron Mining Company under the terms of an agreement.

Under date of October 2, 1899, a lease for fifty years was made by owners of property in Michigan to a lessee, which later assigned to Oliver Iron Mining Company. It gave lessee the right to mine iron ore on a royalty basis (Exhibit A, attached to stipulation and introduced in evidence. Tr. 31).

On January 1, 1946 appellant, by succession in interest, was one of the owners of a percentage interest in said property and entitled to a portion of the payments under that lease. As of that date, appellant and the other interested persons executed a new contract with Oliver covering the next fifty years, termed "Amended Lease" (Exhibit B, Tr. 33). Pertinent provisions thereof are as follows (Tr. p. 18 et seq.):

> "1. That the Lessors, in consideration of the sum of one dollar ($1.00) to them paid by the Lessee, the receipt whereof is hereby acknowledged, and in further consideration of the covenants, conditions, and provisions of this lease to be kept and performed by the Lessee, do hereby let, demise and lease unto the Lessee, for the further term of fifty (50) years from and after the first day of January in the year one thousand nine hundred and forty-six, the following described lands and premises in the County of St. Louis and State of Minnesota, hereinafter referred to as the 'Rust Mine Lands,' to wit:
>
> * * *
>
> 4. The Rust Mine Lands are demised to the Lessee for the purpose of exploring for mining,

taking out and shipping therefrom the merchantable iron ore (as well as other minerals as hereinafter provided for) which is or hereafter may be found on, in or under the Rust Mine Lands, with the right to the Lessee to construct all buildings and to make all excavations, openings, ditches, drains, railroads, roads and all other improvements which are or may become necessary or suitable for the mining or removing of the iron ore therefrom and the carrying on of mining operations thereon. The term 'merchantable ore' as used in this lease shall be taken to mean such ore as shall be merchantable from time to time as the work of mining progresses.

5. The Lessee hereby covenants and agrees to pay to the Lessors a royalty on all iron ore mined and shipped from the Rust Mine Lands while this lease shall remain in force, as follows:

6. Upon the first twenty million (20,000,000) tons of iron ore mined and shipped by the Lessee from the Rust Mine Lands the royalty shall be at the rate of fifty (50) cents for each gross ton of 2240 pounds avoirdupois.

* * *

9. The Lessee further covenants and agrees that for each year prior to January 1, 1966, it will pay to the Lessors the sum of Five Hundred Thousand Dollars ($500,000.00), payable quarterly on the twenty-fifth days of April, July, October and January in each year, irrespective of the quantity of iron ore actually shipped from the Rust Mine Lands during such year or any quarter thereof, and the total amount so paid, including the final payment on January 25, 1966, shall satisfy the royalty of fifty (50) cents per ton on the

first twenty million (20,000,000) tons of ore shipped from the Rust Mine Lands.

10. If, prior to January 1, 1966, less than twenty million (20,000,000) tons of ore shall have been shipped from the Rust Mine Lands, the balance of said twenty million (20,000,000) tons of ore, upon which the royalty shall have been paid as above provided, on or before January 25, 1966, may be shipped, without further payment of royalty thereon, at any time thereafter during the existence of this lease; but the shipment thereof shall not be taken to satisfy or affect in any way the minimum requirements after January 1, 1966, hereinafter provided for.

11. If, prior to January 1, 1966, the Lessee shall ship, as it may, more than twenty million (20,000,000) tons of iron ore from the Rust Mine Lands, the Lessee shall pay to the Lessors, in addition to the quarterly payments to be made as aforesaid, the base royalty on all such ore in excess of the said twenty million (20,000,000) tons shipped during each quarter year, payable on the twenty-fifth day of the month following the end of such quarter; and the excess royalty, if any, thereon, shall be paid on the twenty-fifth day of July of the year following the year in which such ore was shipped.

* * *

47. Notwithstanding any termination of this lease, including the termination of the right of the Lessee thereafter to mine any ore from the Rust Mine Lands, or to ship therefrom any ore theretofore mined, or to continue in possession of the Rust Mine Lands, any unpaid balance of the total amount of Ten Million Dollars ($10,000,-

000) payable as royalty on twenty million (20,-000,000) tons of ore as aforesaid, shall nevertheless be paid by the Lessee to the Lessors in quarterly installments of One Hundred Twenty-Five Thousand Dollars ($125,000.00) each, on the 25th days of April, July, October and January in each year, until said amount is fully paid; and for an adequate consideration such obligation is hereby assumed and agreed to be paid as a continuing corporate obligation of said Lessee."

Appellant contends that the payments received by him in 1947 were not royalty but formed part of the purchase price on a sale of twenty million tons of ore which had been effected under the so-called "Amended Lease" and, therefore, such payments were not ordinary income subject to depletion deduction or credit but were within the provisions of the revenue act covering the sale of capital assets. If he is correct, his loss in 1947 would be greater; his loss carry-back in 1945 would be greater and the tax for 1945 less than if the Commissioner is right in his determination that the payments were royalty.

The Tax Court agreed with the Commissioner.

Other matters were before the Tax Court but they are not involved here.

SPECIFICATION OF ERROR.

The Tax Court erred in determining that the receipts from Oliver Iron Mining Company in 1947

were royalty payments and not payments on the purchase price for twenty million tons of ore.

SUMMARY OF ARGUMENT.

The intention of the parties to the contract of January 1, 1946 entitled "Amended Lease" was to make a sale of twenty million tons of ore and to provide by lease on a royalty basis for the removal of additional ore as desired by Lessee. That intention is so plain that it overcomes any strict construction which might be given to the words "lease" and "royalty" as used in the contract.

ARGUMENT.

Under normal conditions, royalty from leases giving the right to explore for and remove oil, gas, iron ore and similar minerals is ordinary income for tax purposes and lessors are given a percentage deduction for depletion of their property as the mineral is severed from the land. Usually the land has little value and taxpayer's real asset is the mineral deposit. The attention of the courts has been devoted in the past to a consideration of the equitable taxation of the receipts by lessors arising from such leases and the foregoing rule allowing depletion deduction was the result of judicial and, later, statutory determination.

We respectfully submit that the situation now before the court is outside that general or normal rule

and that appellant made a sale of a capital asset, namely, his interest in twenty million tons of ore, in addition to continuing the lease on a royalty basis for whatever ore the Oliver Company might desire beyond the twenty million tons so purchased.

The Supreme Court has said:

> "The facts of each transaction must be appraised to determine whether the transferor has made an absolute sale or has retained an economic interest—a capital investment." (*Kirby Petroleum Company v. Commissioner,* 326 U. S. 599, 606.)

Appellant contends that the facts are these:

The owners of a vast quantity of unmined iron ore sold twenty million tons of it for ten million dollars, payable during twenty years and for that payment the purchaser became individually liable and appellant was not dependent upon ore production for his purchase price.

The remainder of that vast quantity of ore was offered to the same purchaser on a royalty basis, to be paid as ore is mined.

As to the first twenty million tons, the economic interest of appellant passed to the purchaser upon the execution of the agreement. As to ore beyond that tonnage, such economic interest remained in appellant until the ore might be extracted by the lessee. Two separate transactions thus were consummated in one document. The presence of a lease with royalty covering the remainder of the ore in no way qualified the

absolute sale of the twenty million tons. Those two transactions in one agreement have tended to cause confusion in the application of the Revenue Act concerning the money received by the owners for the twenty million tons so sold—outright and forthwith.

If the owners had mined twenty million tons of ore and stored it on the ground they certainly could sell it, in bulk and not in the course of business, for a total consideration based upon a price per ton. That would be a sale of a capital asset and would be entitled to the provisions of the Revenue Act pertaining to that kind of sale. Why should there be a different rule if the ore is unmined? Nobody will disagree that twenty million tons constitute a great quantity—more than would be mined and stockpiled. These parties adopted almost the only available method for such a sale. They could not survey and describe a tract certain to contain that exact amount of ore. If, in addition to the mined ore in the supposition just stated, the owners of that mined ore also possessed a large area of unmined ore of uncertain quality or quantity, which the buyer might want but he did not care to risk an outright purchase at that time, the parties probably would execute a lease on a royalty basis for the unmined ore. Placing the two separate transactions in one contract, covering first the sale and next the lease, might not be the clearest way to record the agreements of the parties but the existence of the rental or royalty transaction could and should not affect the absolute termination of the economic interest of the sellers in the twenty million tons.

Suppose, again, the owner and prospective buyer examined the entire area which the owner possessed (no mining having been done theretofore); they estimated it to contain twenty million tons of ore and they agreed on a sale of that entire area for ten million dollars. That, also, would be a sale of a capital asset. If the contract provided for a price of fifty cents per ton for any excess tonnage which might be mined, the entire transaction would not become thereby a lease with royalty so that the owner would retain an economic interest in any part of the property.

No citation of authority is needed to the effect that agreements are to be construed according to the intention of the parties if that intention can be ascertained from the words used in the contract. Also, where there is doubt and taxation is involved, the construction ought to be favorable to the taxpayer. The name applied to the instrument is not controlling. In *Anderson v. Helvering,* infra, the court stated that the decision in a prior case "did not turn upon the * * * formalities of the conveyancer's art". The agreement of 1946 certainly is entitled to be called a lease upon royalty but that term applies to the excess above twenty million tons. As to the first twenty million tons, it was a conveyance which took from the sellers all their economic interest in that property.

The Supreme Court has stated the effect thereof as follows, in *Anderson v. Helvering,* 310 U.S. 404, 84 L.Ed. 1277:

> "By an outright sale of his interest for cash, such an owner converts the form of his capital investment, severs his connection with the production of oil and gas and the income derived from production * * * ."

We pause to consider the *Anderson* case. The owners of royalty interests, fee interests and deferred oil payments sold them to purchasers for a sum payable partly in cash at the execution of the contract and partly from one-half of proceeds the purchasers might obtain later from sale of any of the purchased items. The purchasers gave no personal obligation but allowed a lien or claim in favor of the sellers on one-half of the proceeds to be derived from subsequent production of oil and gas and from sales of fee interests. Those facts are weaker than the fact of corporate assumption of general liability existing in the case at bar. In Anderson's case the purchase price, except the down payment, was to come entirely out of subsequent production or sales of the property sold. Nevertheless, the court held that sellers had made a sale of a capital asset. The buyers tried to induce the court to decide that part of the subsequent income from production, which was set aside for the sellers as payment on the purchase price, should be taxed as income to the sellers, but the court said it was income to the buyers. In our case the buyer is liable completely apart from the property sold. In the *Anderson* case the Commissioner contended that the court decisions to the effect that royalty and bonus

transactions were income on economic interests should not apply because the seller had more than the oil and gas production to provide payment to him of the purchase price, namely, the seller had a lien on one-half of the proceeds of all sales of both fee and oil and gas. The Commissioner should take the same position here.

The court in the *Anderson* case said, at page 412:

> "Oklahoma Company (seller) is not dependent entirely upon the production of oil for the deferred payments; they may be derived from sales of the fee title to the land conveyed. It is clear that payments derived from such sales would not be subject to an allowance for depletion of the oil reserves, for no oil would thereby have been severed from the ground * * * ."

It is clear that payments for twenty million tons in the case at bar are not dependent upon the mining of any ore and do not necessarily come from the proceeds of ore even if that quantity should be mined. Under the usual royalty lease, royalty is paid out of the proceeds of production.

It seems quite settled that a lease on royalty to be paid as the mineral is mined or produced does not result in the sale of a capital asset and that the lessor is entitled to depletion deduction against the proceeds as a fair substitute for treatment accorded one who has sold a capital asset. In the *Anderson* case, supra, immediately following the foregoing quotation the Supreme Court said (repeating the portion quoted above):

"By an outright sale of his interest for cash, such an owner converts the form of his capital investment, severs his connection with the production of oil and gas and the income derived from production and thus renders inapplicable to his situation the reasons for the depletion allowance. 'The words "gross income from the property," as used in the statute governing the allowance for depletion, mean gross income received from the operation of the oil and gas wells by one who has a capital investment therein,—not income from the sale of the oil and gas properties themselves.' "

The Court determined that the reservation by seller in the *Anderson* case of interests in the oil production and the fee materially affected the transaction and noted that the seller did not depend for the purchase price on oil and gas production alone but had a lien or claim on proceeds from the sale of the fee or part thereof. Here is significant language in the opinion which supports our contention in the case at bar:

"It (the reservation of security) is similar to the reservation in a lease of oil payment rights *together with a personal guaranty of the lessee that such payments shall at all events equal the specified sum.*" (Emphasis added.)

Exactly the situation here! The agreement of 1946 provides:

"47. Notwithstanding any termination of this lease, including the termination of the right of the Lessee thereafter to mine any ore from the Rust Mine Lands, or to ship therefrom any ore theretofore mined, or to continue in possession of the

> Rust Mine Lands, any unpaid balance of the total amount of Ten Million Dollars ($10,000,000) payable as royalty on twenty million (20,000,000) tons of ore as aforesaid, shall nevertheless be paid by the Lessee to the Lessors in quarterly installments of One Hundred Twenty-Five Thousand Dollars ($125,000.00) each, on the 25th days of April, July, October and January in each year, until said amount is fully paid; and for an adequate consideration such obligation is hereby assumed and agreed to be paid as a continuing corporate obligation of said Lessee."

That is a personal guaranty by the lessee and, we think, effectively takes the case out of the orbit described by the cases relied on by the Tax Court, wherein we find no such personal guaranty.

Quoting again from the Anderson opinion:

> "The deferred payments reserved by Oklahoma Company (seller) accordingly, must be treated as payments received upon a sale to petitioners (buyers), not as income derived from the consumption of its capital investment in the reserves through severance of oil and gas."

Which means, of course, that Oklahoma Company, as seller, was not within the provision for depletion deduction but was the seller of a capital asset and the proceeds should be taxed accordingly.

In *Kirby Petroleum Company v. Commissioner,* 326 U.S. 599, 90 L.Ed. 343, the court said, at page 603:

> " * * * only a taxpayer with an economic interest in the asset, here the oil, is entitled to the depletion (citing cases). By this is meant only that

> under his contract he must look to the oil in place as the return of his capital investment. The technical title to the oil in place is not important."

In our case, appellant does not look to or depend upon the ore for his sale price; he looks to the corporation purchaser and he can institute an action in assumpsit any time the prescribed payments are not forthcoming to him. Upon a judgment, execution may proceed against the twenty million tons or any other asset of the purchaser. If mining operations cease at any time, the sellers are not affected as to the ten million dollars. How, then, can appellant obtain depletion under the language we have just quoted from the *Kirby* case? If he cannot get depletion and if he cannot (under the decision of the Tax Court) come under the provisions for sale of capital assets, he is surely in a bad way and obtains no credit whatever for his capital investment with respect to the twenty million tons.

Turning again to the *Kirby* case, we find that the court interpreted its decision in the *Anderson* case, as follows:

> " * * * we held the operator liable as a purchaser because the seller was not 'entirely dependent' upon the oil production for his purchase price. This gave the operator the benefit of the applicable depletion."

Therefore, if the seller is not entirely dependent upon the oil production for his purchase price, he has sold a capital asset.

The "personal guaranty" feature appeared in *Helvering v. Elbe Oil Land Development Company,* 303

U.S. 372, 82 L.Ed. 905, where Elbe sold all his right, title and interest in oil and gas property and the purchaser agreed to make periodic payments of stated amounts and also to give Elbe one-third of the net profits resulting from operations. Elbe tried to claim depletion credit against the operation income but the court denied the claim. The language of the agreement was very clear that a sale had been intended but, we think, not more clear than the agreement in our case when carefully read and construed. As to the sharing of the production income, the court said, at page 375:

> "We are unable to conclude that the provision for this additional payment qualified in any way the effect of the transaction as an absolute sale *or was other than a personal covenant of the (buyer).* * * * In this view, neither the cash payments nor the agreement for a share of subsequent profits constituted an advance royalty or a 'bonus' in the nature of an advance royalty, within the decisions recognizing a right to the depletion allowance with respect to payments of that sort. Such payments are made to the recipient as a return upon his capital investment in the oil and gas in place. (citing cases) Payments of the purchase price which are received upon a sale of oil and gas properties are in a different category. The words 'gross income from the property,' as used in the statute governing the allowance of depletion, mean gross income received from the operation of the oil and gas wells by one who has a capital investment therein, — not income from the sale of oil and gas properties themselves. (citing cases) We conclude that as respondent disposed

> of the properties, retaining no investment therein, it was not entitled to make the deduction claimed for depletion." (Emphasis added.)

We should not forget that the original document executed in 1899 was properly a lease for fifty years and no sale was then contemplated except as the ore was mined. As the term approached completion, the parties desired a renewal, — plus a new feature. The latter was an outright sale. Beyond that sale there was a continuation of the leasing privilege, to be paid as ore is mined. Perhaps we would have phrased the amending document in a different fashion, but no matter what other words might be changed to more clearly indicate a sale, no words could be plainer than those in paragraph 47 to give what the original lease did not contain, namely, a liability for the purchase of ore entirely apart from the mining of that ore.

We contend that appellant disposed of his share of twenty million tons of ore and took for that a personal covenant of the buyer. Under the foregoing language, he cannot claim depletion and must be entitled to treat the transaction as a sale of a capital asset.

Dated, Reno, Nevada,
March 23, 1955.

Respectfully submitted,

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